

STANDARD &POOR'S	RATINGS DIRECT

RESEARCH**Hawaii; Tax Secured, General Obligation**

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Credit Profile

US\$350. mil GO bnds ser 2006 DI due 03/01/2026 AA -
 Sale date: 08-MAR-2006

AFFIRMED

\$3.957 bil. Hawaii GO	AA -
\$947.575 mil. Hawaii GO (AMBAC)	AAA/AA-(SPUR)
\$16.250 mil. Hawaii GO (FGIC)	AAA/AA-(SPUR)
\$188.650 mil. Hawaii GO (FSA)	AAA/AA-(SPUR)
\$252.310 mil. Hawaii GO rfdg bnds of 1998 ser CS dtd 04/01/1998 due 04/01/2003-2009	AAA/AA-(SPUR)
\$225.900 mil. Hawaii go bnds (MBIA)	AAA/AA-(SPUR)
\$456.750 mil. Hawaii go bnds ser 2001 dtd 08/01/2001 due 08/01/2005-2021	AAA/AA-(SPUR)

OUTLOOK: POSITIVE

Rationale

Standard & Poor's Ratings Services assigned its 'AA-' rating to Hawaii's \$350 million GO bonds, series 2006DI, and affirmed its 'AA-' rating on Hawaii's \$3.95 billion in outstanding GO debt. The rating reflects the state's:

- Tourism-based but gradually diversifying economy, currently in the midst of an expansionary phase, with average wealth and income indicators; and
- Improved financial position bolstered by strong revenue trends and the proposed allocation of a portion of surplus revenues to the state's emergency budget reserve.

Offsetting these strengths are the state's high debt burden and the low funded status of its retirement system. In addition, longer-term pressures on the state's economy include a high cost of living and, in particular, housing affordability.

The bonds are secured by the full faith and credit pledge of the state. Much of the proceeds from the series 2006DI bonds will be used for various new public projects, buildings, community colleges, university, libraries, and parks. In addition, funds will finance infrastructure projects targeted for the K-12 education system.

According to a variety of measures, Hawaii's economy appears at the peak of its business cycle, with some of the state's significant economic sectors performing at record levels. In tourism, the state saw record visitor arrivals to just under 7.4 million in 2005, while robust construction activity in the state pushed job growth in that sector up by 10%. Similar to recent years, the very strong tourist arrival numbers (6.76% growth in 2005) are mainly supported by robust trends in domestic visitors (up 7.4%), though with modest growth in international visitor arrivals (up 5.22%); this follows a period of anemic international visitor arrival numbers early in the decade. Cumulative visitor arrivals totaled 7.38 million in 2005, above the record set in 2000. These strong trends translated to a very high average hotel occupancy rate in 2005 of 81.5%,

above the prior peaks in recent years of 76.5% in 2000 and 77.7% in 2004.

The decrease and then recovery in arrivals over the past four years has had a net positive impact on Hawaii's total employment figures, thanks to additional support from strong trends in construction, government and finance, insurance, and real estate. At 606,000 total jobs in 2005, the increase in Hawaii's civilian employment was one of the largest in the nation at 2.7%. For the year, unemployment was 2.8%, also a very favorable level compared to other states in the nation and down significantly from 2003, when unemployment was at 4.3%. Moreover, the state has not experienced a dramatic increase in applications for welfare. Personal incomes continue to grow and were up 7.0% in 2005, ahead of the already strong pace of 5.0% and 8% achieved in 2003 and 2004, respectively. This strong growth and virtually full-employment status makes the potential for upward wage pressure and possible increased inflation more likely, which may ultimately cause economic growth to moderate over the next several years. Importantly, the state's economy is showing indications of gradual diversification as measured by composition of total state earnings. Whereas in 2001 some 25.5% of total earnings were attributable to tourist related economic activities, in 2005 tourism accounted for 21% of total earnings.

Indicative of the robust economic growth, state tax revenues (general excise, income, and other) grew by 16% in fiscal 2005, up from an already strong growth rate of 8.3% in fiscal 2004. Thus far at mid-fiscal 2006, tax revenues are growing at a 14% rate, well above the council on revenues forecast of 8.0%. On a budgetary basis, fiscal 2005 ended with a \$302 million surplus (7.2% of expenditures), up from fiscal 2004, when a surplus of \$117 million was posted. The trend in recent years compares very favorably to 2002 and 2003, in which deficits of \$215 million (5.9% of expenditures) and \$16.8 million were recorded. Hawaii's ending budget reserve in fiscal 2005 was \$486.4 million, or 11.6% of expenditures, up from \$184.6 million, or 4.8% of expenditures, the prior year. For fiscal 2006, the state anticipates a \$574.4 million reserve, equivalent to 12.3% of expenditures. In her recently proposed 2007 supplemental budget, the governor proposed investing the surplus in tax relief, increased funding for certain programs, and an increased contribution to the state's emergency budget reserve. Major components of the proposed supplemental budget currently working its way through the legislature include \$157 million of ongoing adjustments to the state income tax and \$128 million of a one-time tax refund. Spending initiatives include \$140 million of increases to education, \$20 million for affordable housing projects, and \$20 million of proposed supplemental spending to meet expand the state's Medicaid coverage to 29,000 additional low-income adults and children over the next six years.

The state's budget reserves cited thus far do not include balances held in its emergency budget reserve fund. The emergency budget reserve (EBR) fund was established in 1999 and currently receives 24.5% of the state's tobacco settlement money. As of June 30, 2005, the fund had a balance of \$54.1 million and expects a balance of \$55.1 million at the end of fiscal 2006. In recent years, the state legislature has appropriated approximately \$10 million per year to keeping the balance at approximately \$50 million; funds subsequently kept from the EBR. Per the governor's proposed supplemental budget for fiscal 2007, the state will infuse the fund with an additional \$64.6 million, bringing the balance in this fund to \$119.7 million by the end of fiscal 2007. Nonetheless, at its current level of \$55.1 million, the fund stands at a relatively low 1.2% of expenditures. If the governor's proposal to increase the contribution is approved, the balance will increase to \$119.7 million, or 2.3% of expenditures. Although the emergency budget reserve is small relative to total state expenditures, the establishment and maintenance of the fund represent an important step toward institutionalizing prudent financial management policies for the state. Suggestive of this financial conservatism is that appropriations from this fund require a two-thirds majority vote of both houses of the legislature. Similarly, soon after taking office, the governor publicly committed to maintaining the state's \$184 million hurricane relief fund, which had been identified in early fiscal 2003 as a potential one-time source available to balance the then-developing 2004 budget.

Hawaii's debt burden is high, with about \$3.95 billion of state GO debt translating to a high per capita level of \$3,340 and 10% of personal income. On a comparative basis the ratio is somewhat inflated, however, because Hawaii issues all debt for its schools, which, for most states, is issued at the local level. In addition to its bonded debt, the state has liabilities associated with its employee retirement system. Because of poor stock market performance early in the decade, salary increases above the actuarially assumed level, and several years when the state did not make its full actuarially based contribution, the funded status of the system has declined each year since 2000 to a low 68.6% from 94.9% in 2000. The state has not quantified its liability related to other post-employment benefits.

Outlook

The positive outlook continues to reflect the state's improved economic and financial position, which allows for increased reserve fund levels and the projection of surplus operations through at least fiscal 2009.

Should the state's improved financial position be maintained, and retiree obligations, including pensions and other postretirement employee benefits (OPEB), prove to be manageable, a higher rating could result. If these conditions are not met, the rating outlook could be revised to stable.

Economy

Hawaii's economy remains significantly reliant on tourism, an industry that currently has mixed but improving conditions. Global security concerns and a weak dollar abroad have enhanced the state's appeal for domestic tourists, while indications of a long-awaited recovery in Japan are finally appearing, and international arrivals were up a strong 5.22% in 2005. This recent improvement and stabilization, combined with a robust construction sector, contribute to the good performance of Hawaii's economy, with positive job growth trends. In fact, 2005 was the state's seventh consecutive year of job growth and ninth straight year of real income growth in the state. At 2.8%, overall job growth in 2005 was above what had been projected. Job growth has been in construction- and military-related employment, with the most recent growth beginning to occur in the leisure and hospitality sectors.

Wealth And Income Indicators Revealed Some Softness, However, With 2003 Data indicating median household effective buying income (EBI) and per capita EBI in 2003 at 100.9% and 89.5%, respectively, of national figures. Both figures were down in 2001 from 2000, most likely from the incorporation of census data, but were down further in 2003 compared to 2002.

Finances

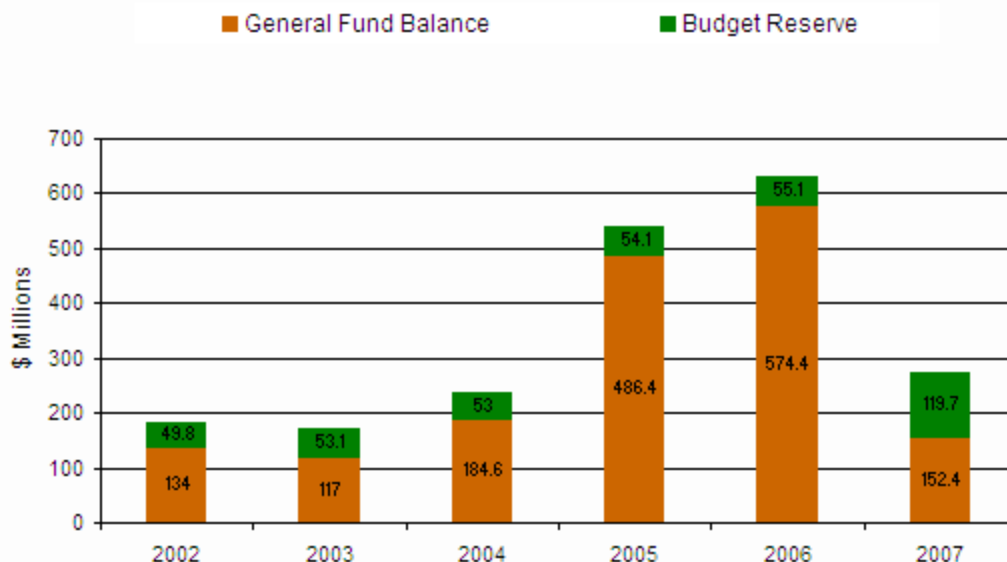
As Hawaii's economy improved in the latter 1990s, the state was able to restore and somewhat institutionalize its financial health. After a dip in financial condition in the early part of the current decade, the state's fiscal condition is now on solid footing, with audited reserves at historically high levels. On an audited basis, the state ended fiscal 2005 with an unreserved fund balance of \$746 million, equivalent to 19.2% of expenditures. Hawaii's unreserved fund balance is now at its peak levels, roughly equivalent to where it stood in the late 1990s (as a percent of expenditures) and up from 8.3% of expenditures in 2003. Fiscal 2005 operating revenues, which grew 16%, were mostly from the state's general excise and use taxes (51% of revenues) followed by the individual income tax (33%). The budget for fiscal 2007 calls for 53% of operating expenditures to be allocated to education (including K-12 and higher education). Human services and health-related expenditures total 24.5% of spending. The general fund operating budget is proposed to grow by \$448.8 million (11%) in fiscal 2006 and \$95.7 million (10.9%) in fiscal 2007. Fixed costs will consume 78% of the new spending in fiscal 2006 and 84% of the new spending in fiscal 2007. After covering the fixed costs, the increase in the budget is much lower at 2.2% in fiscal 2006 and 2% in fiscal 2007. However, the state will still contribute to its emergency budget reserve, which is estimated to have a balance of \$53.5 million at the close of fiscal 2006. Interest earnings of the emergency budget reserve are credited to the general fund.

As noted, in 1999, the state created an emergency budget and reserve special fund to be funded with a portion of proceeds from money received from the tobacco companies. While the dollar amount is not significant relative to the state's budget, this rainy day fund provides some additional financial cushion. Before the Sept. 11, 2001, terrorist attacks, Hawaii was allocating 40% of its tobacco settlement money, with interest income accruing, to the general fund. Legislation from a special session in the fall of 2001 reduced that percentage to 24.5%. As of June 30, 2005, the balance in the emergency and budget reserve was \$54.1 million, compared to \$54 million the previous year. The state projects this balance to grow to \$119.7 million by the end of fiscal 2007 if the legislature adopts the governor's proposal.

Debt

Hawaii's debt ratios are high, with direct state debt--including these 2006 series of bonds--at about \$3,340 per capita. In addition to its bonded debt, the state's retirement system has an unfunded actuarial accrued liability of \$4.07 billion, representing a funded ratio of 68.6%, down from 2000 when the funded ratio stood at 94.9%. In addition, the state will be recognizing its OPEB liability in fiscal 2008, an amount currently unknown but likely to be significant. The generally high per capita debt levels in Hawaii are attributable to the state's assumption of many functions that in other states are generally financed by local governments, including local education, health, and welfare. Debt levels, however, rose rapidly during the 1990s, as the state shifted from pay-as-you-go capital spending to GO bonds. Hawaii's state debt is among the highest of all the U.S. states, and debt servicing consumed 10.9% of general resources in fiscal 2001. Debt amortization is aggressive, however, with 73% of principal repaid in the next 10 years and 100% in 20 years. Because the state's debt is front-loaded--with the bulk of principal scheduled for amortization in 2006-2009--the current issuance does not begin repaying principal until 2010, the latest allowed under the state constitution. This structure allows the state's debt service to become somewhat more level.

Chart 1

HI's Budget Reserve Portion Of General Fund

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